

CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

As management of the City of Rochester, Minnesota, we offer readers of the City of Rochester's financial statements this narrative overview and analysis of the financial activities of the City of Rochester for the fiscal year ended December 31, 2002. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal, which can be found on pages i - v of this report.

FINANCIAL HIGHLIGHTS

- The assets of the City of Rochester exceeded its liabilities at the close of the most recent fiscal year by \$482,765,007 (*net assets*). Of this amount, \$108,105,189 (unrestricted net assets) may be used to meet the City's ongoing obligations to citizens and creditors in accordance with the City's fund designations and fiscal policies.
- The City's total net assets increased by \$44,839,175.
- As of the close of the current fiscal year, the City of Rochester's governmental funds reported combined ending fund balances of \$102,245,993. Approximately 40 percent of this total amount, or \$41,167,905 is available for use within the City's designations and policies.
- At the end of the current fiscal year, unreserved fund balance for the general fund was \$15,108,702 or 37 percent of total general fund expenditures.
- The City of Rochester increased total outstanding debt obligations by \$11,196,301 during the current fiscal year.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis are intended to serve as an introduction to the City of Rochester's basic financial statements. The City of Rochester's basic financial statements comprise three components:

1. Government-wide financial statements, providing information for the City as a whole.
2. Fund financial statements, providing detailed information for the City's significant funds.
3. Notes to the financial statements, providing additional information that is essential to understanding the government-wide and fund statements.

This report also contains other supplementary information in addition to the basic financial statements themselves.

Additional explanation of these sections of the financial statements follows.

CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

Government-wide financial statements. The *government-wide financial statements* are designed to provide readers with a broad overview of the City of Rochester's finances, in a manner similar to a private-sector business.

The *statement of net assets* presents information on all of the City of Rochester's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the City of Rochester is improving or deteriorating.

The *statement of activities* presents information showing how the City's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of the related cash flows*. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned, but not used, compensated absences).

Both of the government-wide financial statements distinguish functions of the City of Rochester that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the City of Rochester include general government, public safety, public works, airport, library, economic development/tourism, transit, culture, parks and recreation and community reinvestment. The business-type activities of the City of Rochester include parking, municipal electric and water utility, and the sewer utility. The electric and water utilities, comprising the Rochester Public Utilities (RPU), are under the direction of the Board of Public Utilities.

The government-wide financial statements can be found on pages 19-21 of this report.

Fund financial statements. A *fund* is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City of Rochester, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City of Rochester can be divided into two categories: governmental funds and proprietary funds.

Governmental funds. *Governmental funds* are used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on *near-term inflows and outflows of spendable resources*, as well as on *balances of spendable resources* available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial requirements.

CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

The City of Rochester maintains twelve individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the general fund and the construction improvement capital projects fund, both of which are considered to be major funds. Data from the other ten governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of *combining statements* elsewhere in this report.

The City of Rochester adopts an annual appropriated budget for its general fund and certain special revenue funds. Budgetary comparison statements have been provided for the general fund (pages 28-29) and the special revenue funds (pages 84-89) to demonstrate compliance with the budget.

The basic governmental fund financial statements can be found on pages 24-29 of this report.

Proprietary funds. The City of Rochester maintains two different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. The City of Rochester uses enterprise funds to account for its parking, electric, water and sewer utilities. *Internal service funds* are an accounting device used to accumulate and allocate costs internally among the City of Rochester's various functions. The City of Rochester uses internal service funds to account for its fleet of vehicles, its risk management program, and for its management information systems. Because all of these services predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for the parking, electric, water and sewer utilities, all of which are considered to be major funds of the City of Rochester. Conversely, all three internal service funds are combined into a single, aggregated presentation in the proprietary fund financial statements. Individual fund data for the internal service funds is provided in the form of *combining statements* elsewhere in this report.

The basic proprietary fund financial statements can be found on pages 30-37 of this report.

CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 40-76 of this report.

Other information. The combining statements referred to earlier in connection with nonmajor governmental funds and internal service funds can be found on pages 80-95 of this report.

IMPORTANT REMINDERS:

Comparative Data. Because this is the first year of presenting the City's financial statements under the new standard, comparison to the prior year is not possible. In subsequent years, this section will discuss and analyze significant differences.

Infrastructure Assets. While the City of Rochester is implementing GASB Statement #34 for its fiscal year ended December 31, 2002, the City is deferring implementation of the retroactive infrastructure portion for general government activities until a final revaluation is completed. Historically, governmental fixed assets, particularly infrastructure assets, have only been accounted for using the current financial resources (budgeted resources) method, and have not been expensed annually through depreciation or accounted for otherwise. Additionally, significant infrastructure assets have been constructed by developers and contributed to the City over the years but have never been recorded. We are currently undertaking a project to inventory and value all of our retroactive infrastructure systems over the allowable three-year period and will include these assets in the financial statements as completed. Nonetheless, the City of Rochester has significant reserves in the capital project funds and an ongoing program for repairs, reconditioning, and replacement of these assets with annual funding sources continually earmarked for these specific purposes. All 2002 and future acquisitions of infrastructure assets have and will be recorded under the new reporting model.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City of Rochester, assets exceeded liabilities by \$482,765,007 at the close of the most recent fiscal year.

By far the largest portion of the City of Rochester's net assets (67 percent) reflects its investment in capital assets (e.g. land, buildings, vehicles, and equipment), less any related debt used to acquire those assets that is still outstanding. The City of Rochester uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the City of Rochester's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

City of Rochester's Net Assets

	Governmental Activities	Business-Type Activities	Total
Current and other assets	\$ 137,584,007	\$ 61,115,631	\$ 198,699,638
Capital assets	<u>206,347,169</u>	<u>196,368,578</u>	<u>402,715,747</u>
Total assets	<u>343,931,176</u>	<u>257,484,209</u>	<u>601,415,385</u>
Long-term liabilities outstanding	43,420,799	57,138,869	100,559,668
Other liabilities	<u>8,467,061</u>	<u>9,623,649</u>	<u>18,090,710</u>
Total liabilities	<u>51,887,860</u>	<u>66,762,518</u>	<u>118,650,378</u>
Net assets:			
Invested in capital assets, net of related debt	168,724,953	153,952,827	322,677,780
Restricted	51,472,992	509,046	51,982,038
Unrestricted	<u>71,845,371</u>	<u>36,259,818</u>	<u>108,105,189</u>
Total net assets	<u>\$ 292,043,316</u>	<u>\$ 190,721,691</u>	<u>\$ 482,765,007</u>

A portion of the City of Rochester's net assets (11 percent) represents resources that are subject to external restrictions on how they may be used. The remaining balance of *unrestricted net assets* (\$108,105,189) may be used to meet the government's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the City of Rochester is able to report positive balances in all three categories of net assets, both for the government as a whole, as well as for its business-type activities.

Governmental activities. Governmental activities increased the City of Rochester's net assets by \$37,827,637, accounting for 84 percent of the total growth in the net assets of the City of Rochester. The most significant change in governmental net assets is due to the effect of accounting for net assets under the full accrual basis. Under full accrual accounting, current year infrastructure capital outlay, which was funded during the year, will be expensed over its useful life. Additionally, developers contributed significant infrastructure assets that were recognized as revenue in the current year.

Business-type activities. Business-type activities increased the City of Rochester's net assets by \$7,011,538 accounting for 16 percent of the total growth in the City's net assets. The City's electric utility contributed the most significant portion of that increase, or \$5,461,154.

**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

A condensed version of the Statement of Activities follows:

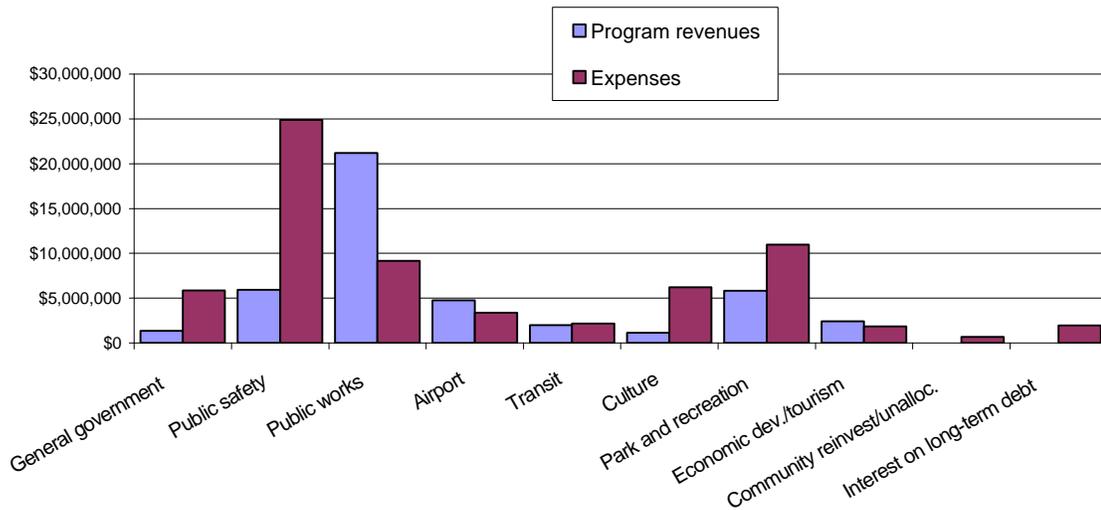
City of Rochester's Change in Net Assets

	Governmental Activities	Business-Type Activities	Total
Revenue:			
Program revenues:			
Charges for services	\$ 12,182,673	\$ 108,729,957	\$ 120,912,630
Operating grants and contributions	5,638,107	6,922	5,645,029
Capital grants and contributions	26,777,358	1,339,950	28,117,308
General revenues:			
Property taxes	20,474,967	229,529	20,704,496
Other taxes	14,050,149		14,050,149
Grants and contributions not restricted to specific programs			
Other	11,798,019	32,939	11,830,958
	<u>5,308,676</u>	<u>1,654,168</u>	<u>6,962,844</u>
Total revenues	<u>96,229,949</u>	<u>111,993,465</u>	<u>208,223,414</u>
Expenses:			
General government	5,851,253		5,851,253
Public safety	24,902,138		24,902,138
Public works	9,151,080		9,151,080
Airport	3,361,247		3,361,247
Transit	2,147,409		2,147,409
Culture	6,205,147		6,205,147
Park and recreation	10,965,066		10,965,066
Economic development/tourism	1,822,976		1,822,976
Community reinvestment/unallocated	669,016		669,016
Interest on long-term debt	1,949,974		1,949,974
Parking		2,846,621	2,846,621
Electric		80,739,625	80,739,625
Water		4,280,928	4,280,928
Sewer		8,491,759	8,491,759
Total expenses	<u>67,025,306</u>	<u>96,358,933</u>	<u>163,384,239</u>
Increase in net assets before transfers	29,204,643	15,634,532	44,839,175
Transfers	<u>8,622,994</u>	<u>(8,622,994)</u>	
Increase in net assets	37,827,637	7,011,538	44,839,175
Net assets, 1/1/02	<u>254,215,679</u>	<u>183,710,153</u>	<u>437,925,832</u>
Net assets, 12/31/02	<u>\$ 292,043,316</u>	<u>\$ 190,721,691</u>	<u>\$ 482,765,007</u>

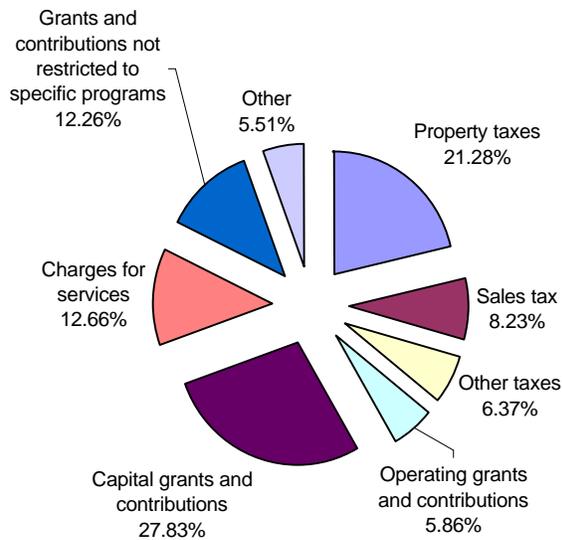
CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

Below are specific graphs that provide comparisons of the governmental activities direct program revenues with their expenditures. Any shortfalls in direct revenues are primarily supported by property tax levy or general state aid.

Expenses and Program Revenues - Governmental Activities



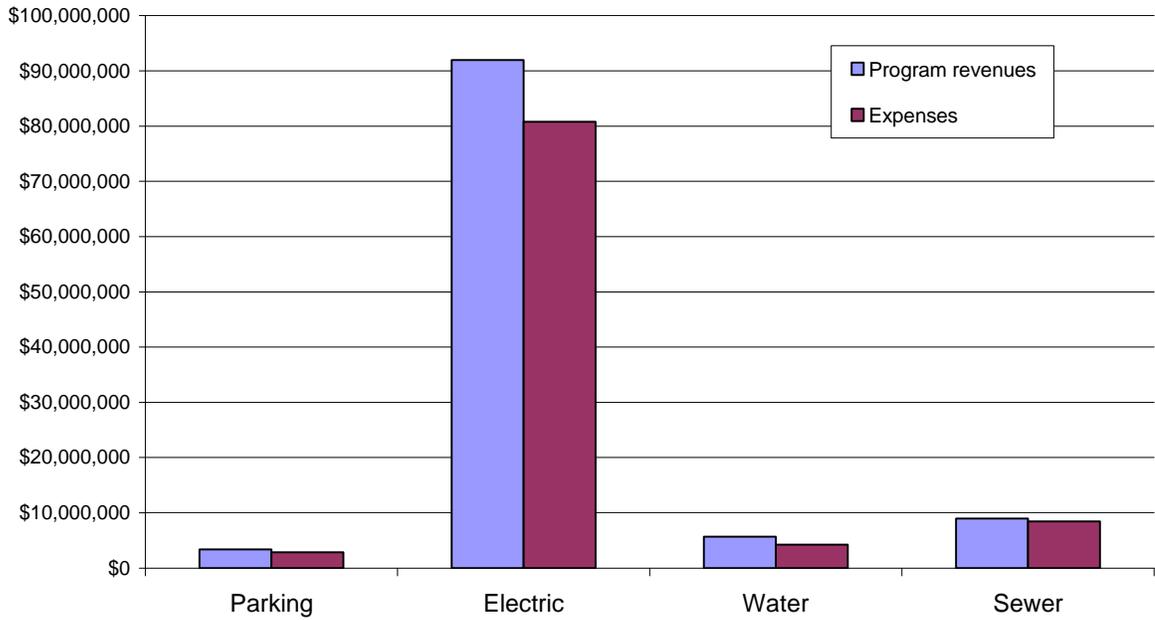
Revenues by Source - Governmental Activities



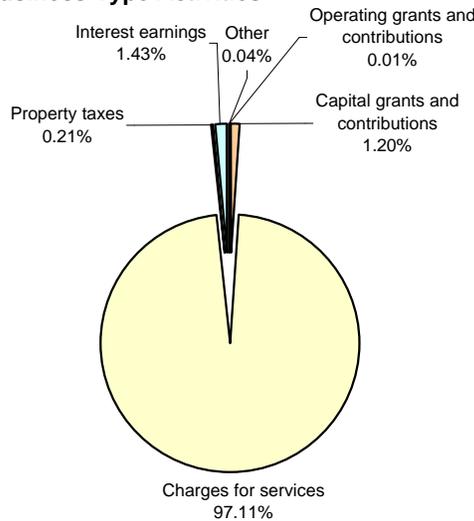
**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following graphs relate the various business-type activities' program revenues with their expenditures. Since all four of these activities require significant physical assets to operate, any excess revenues are held for planned capital expenditures to keep pace with growing demand for services.

Expenses and Program Revenues - Business-Type Activities



Revenues by Source - Business-Type Activities



**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Financial Analysis of the Government's Funds

As noted earlier, the City of Rochester uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds. The focus of the City of Rochester's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the City of Rochester's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the City of Rochester's governmental funds reported combined ending fund balances of \$102,245,993, an increase of \$1,655,026. Approximately 40 percent of this total amount, or \$41,167,905, constitutes *unreserved fund balance*, which is available for spending at the government's discretion. The remainder of this fund balance is *reserved* to indicate that it is not available for new spending because it has already been committed 1) to liquidate contracts and purchase orders of the prior period (\$9,317,523), 2) to repay interfund advances or other debt (\$5,929,293), or 3) to fund specific capital projects or programs as obligated by statute or other regulation (\$45,831,272).

The general fund is the chief operating fund of the City of Rochester. At the end of the current fiscal year, unreserved fund balance of the general fund was \$15,108,702 while total fund balance fell slightly to \$16,108,970. As a measure of the general fund's liquidity, it may be useful to compare unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents 37 percent of total general fund expenditures, while total fund balance represents 40 percent of that same amount.

The general fund's total fund balance decreased by \$309,714 during the current fiscal year. This year's decrease was primarily due to a budgeted \$1.5 million equity transfer to the capital projects funds to provide for needed road improvements. Revenues met or exceeded budget projections in most all cases and expenditures were at or below planned levels. Were it not for this equity transfer, fund balance in the general fund would have grown by nearly \$1.2 million during the year.

The library fund decreased its fund balance by \$78,464 for the year as it spent \$105,475 of its previously received gifts appropriations. The recreation fund increased its fund balance by \$98,286 as its charges for services exceeded budget amounts and total expenditures came in under budget. The airport fund increased its total fund balance by \$228,997 for the year to \$2,768,891.

The debt service funds have a total fund balance of \$3,056 all of which is reserved for the payment of debt service. This fund balance remained essentially unchanged for the year, as transfers in from other funds provided monies for all debt service payments.

The construction improvement fund increased fund balance by \$1,666,195 despite total expenditures on projects of \$31,122,527. This increase is largely due to receipt of sales tax revenues that are being held for approved projects.

CITY OF ROCHESTER, MINNESOTA MANAGEMENT'S DISCUSSION AND ANALYSIS

Proprietary funds. The City of Rochester's proprietary funds statements found on pages 30 - 37 provide the same type of information found in the government-wide financial statements, but in more detail.

The unrestricted assets in the respective proprietary funds are Electric – \$13,669,570, Water -- \$1,866,491, Sewer - \$11,767,248 and Parking - \$9,179,587. All but the sewer utility fund had increases in total net assets for the year. The sewer utility fund's decrease of \$95,790 was due to a transfer of \$526,260 to capital projects funds for sewer main construction.

Rates were increased in all proprietary funds during 2002. The electric utility's rates were increased an average of 3 percent during fiscal year 2002. These rate increases were necessary to fund increased operating expenditures and to finance expansion in the system.

The water utility's rates were increased an average of 4 percent during 2002 as the utility took on all maintenance and repair of existing water lines and the City ended its practice of using special assessments to recover these costs.

The parking fund's rate increases varied widely by type of parking space as the City attempted to incent monthly parking contract holders to utilize ramps further from the downtown core thereby freeing up those spaces for short-term visitors and retail customers. Some rates were increased as much as 25 percent.

The sewer utility's rates were increased for fiscal year 2002 by an average of 2.5 percent as the utility continued to plan for its major plant expansion and the anticipated debt service required to repay those costs.

General Fund Budgetary Highlights

The City approved the 2002 general fund budget anticipating a reduction in general fund reserves of \$1.5 million, primarily due to the planned transfer to the capital improvements program. The City amended its budget to recognize additional unplanned obligations during the year and partially offset this with additional revenue streams.

Differences between the original budget and the final budget can be briefly summarized as follows:

- Increase in Nonproperty Taxes and Economic Development Expenditures as the State Legislature approved an increase in the City's lodging tax rate from 3 percent to 4 percent with the increase going to the Rochester Convention and Visitor's Bureau.
- Increase in the Mayor & Council budget and City Attorney budget to cover unplanned expenditures for legal consultants and lobbying efforts, funded by a reduction in the contingency budget.
- Increase in various departmental budgets to appropriate intergovernmental revenues from state or federal grants.
- Increases in culture expenditures and other fee-based activities with offsetting increases to charges for services revenue budgets.

**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

At the close of the year, only \$309,714 of the planned \$1.5 million was actually used from general fund reserves for the capital improvement program. Total expenditures were \$1,634,176 below final budget and actual revenues exceeded final budget by \$563,297.

Capital Asset and Debt Administration

Capital assets. The City of Rochester's investment in capital assets for its governmental and business-type activities as of December 31, 2002, amounts to \$402,715,747 (net of accumulated depreciation). This investment in capital assets includes land, buildings, improvements, machinery and equipment, park facilities, roads, highways, and bridges. The total increase in the City of Rochester's reported investment in capital assets for the current fiscal year was \$49,490,073, or 14 percent. Most of this increase within the governmental activities can be found in the addition of constructed or donated streets and underground infrastructure, or the acquisition of parkland (Cascade Lake and McQuillian Field). Within the business-type activities the most significant increases occurred in acquisition of machinery and equipment as the electric utility completed construction of its peak power generator and the sewer utility increased plant equipment assets.

Again, it should be noted that these totals do not include "retroactive infrastructure", or those roads, bikeways, sewer and water mains acquired prior to this year. Under the new reporting guidelines, these assets will be included in the City's financial statements over the next three years.

City of Rochester's Capital Assets

(net of depreciation)

	Governmental Activities	Business-Type Activities	Total
Land	\$ 43,907,978	\$ 5,721,046	\$ 49,629,024
Buildings	72,520,053	62,295,492	134,815,545
Improvements other than buildings	4,807,427		4,807,427
Machinery and equipment	23,451,359	114,481,983	137,933,342
Infrastructure	17,087,574		17,087,574
Construction in progress	44,572,778	13,870,057	58,442,835
Total	\$ 206,347,169	\$ 196,368,578	\$ 402,715,747

Additional information on the City of Rochester's capital assets can be found in Note 3:E. on pages 55-57 of this report.

Long-term debt. At the end of the current fiscal year, the City of Rochester had \$92,881,641 in bonds and notes outstanding. Of this amount, \$45,291,641 comprises debt backed by the full faith and credit of the government and \$47,590,000 represents bonds or notes secured solely by specified revenue sources.

**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

City of Rochester's Outstanding Debt

General Obligation and Revenue Bonds and Notes Payable

	Governmental Activities	Business-Type Activities	Total
General obligation bonds	\$ 6,358,611	\$ 7,620,000	\$ 13,978,611
Revenue bonds	28,383,673	47,390,000	75,773,673
Notes payable	2,929,357	200,000	3,129,357
Total	\$ 37,671,641	\$ 55,210,000	\$ 92,881,641

The City of Rochester's total bonds and notes payable increased by \$11,196,301 during the current fiscal year. New debt included a revenue bond for electric utility system improvements and expansion issued by the Rochester Public Utility in the amount of \$11,275,000. Additionally, the City drew \$2.5 million on its Sales Tax Revenue Note of 2001 for certain roadway improvements. A total of \$2,686,818 in bonds and notes payable was retired during 2002. A more detailed breakdown of these obligations can be found in Note 3:H., beginning on page 61.

The City of Rochester maintains an AAA bond rating on its general obligation bonds from both Moody's Investors Service and Standard and Poors. Rochester Public Utility has received an Aa3 rating from Moody's and an A+ on its Utility Revenue Bonds.

Economic Factors and Next Year's Budgets and Rates

- The unemployment rate for the City of Rochester ended the first quarter of 2003 at 4.1 percent, which is at approximately the same level as a year ago. This compares favorably to the state's average unemployment rate of 4.9 percent and the national average rate of 6.4 percent.
- Despite recent manufacturing job loss, Rochester continues to see new construction growth, not only in residential, but also in commercial construction with record or near record levels each month. The City's total market valuation increased by 5 percent due to new construction for taxes payable in 2003.
- Property tax reforms and budget deficits at the state level have significantly impacted government aid payments made to the City. Rochester's state aid was reduced for both 2003 and beyond by approximately \$3.3 million.
- Interest rates have continued to fall over the past few years such that the City's investment portfolio return has been reduced significantly.

**CITY OF ROCHESTER, MINNESOTA
MANAGEMENT'S DISCUSSION AND ANALYSIS**

All of these factors were considered in preparing the City of Rochester's budget for the 2003 fiscal year. To deal with both cycles in the economy and to plan for future capital expansion, the City routinely puts aside resources. Expenditure budgets for 2003 were held back and are now being formally amended based on the state's aid reduction. The City will likely utilize some reserves in 2003 and will be looking to reduce some levels of service in 2004 to adjust for these cuts.

Requests for Information

This financial report is designed to provide a general overview of the City of Rochester's finances for all those with an interest in the City's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Office of the Finance Director, 201 4th Street SE, Room 204, Rochester, MN 55904.

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